



Office of the City Auditor

Medical Leave Payoff or Conversion Report No. 0512

April 1, 2005

City staff has focused on implementing appropriate controls to ensure that calculations are correct, liability is tracked, and premiums are accurately charged against benefits. Now that controls are in place, focus should be redirected to a review of the conversion policy for the purpose of modifying either practice or City Code to eliminate the need for policy interpretation.

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April 1, 2005

To the Most Honorable Mary Manross, Mayor
and Members of the Scottsdale City Council

Transmitted herewith is a report on Medical Leave Payoff or Conversion, Report No. 0512. Staff in Human Resources and Financial Services were very cooperative during our audit and we would like to thank them for their assistance.

If you need additional information or have any questions, please contact me at 480-312-7756.

Respectfully submitted,

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EXECUTIVE SUMMARY

Procedures, currently in place, provide reasonable assurance that the value of accrued medical leave at retirement will be accurately calculated. We selected a sample of retirees from calendar year 2003 and 2004 and traced all values to supporting documentation to verify rate of pay, accrued hours, and calculation of deductions, if appropriate. We found no exceptions in the calculations.

Procedures are also sufficient to ensure that balances will be tracked and premiums accurately posted. We tested beginning amounts, recomputed premiums, and recalculated ending balances to check the accuracy of entries. All transactions tied to records maintained by Human Resources with the exception of three errors dating back to early 2003. As well, the total value for individual balances agreed, after timing adjustments, to the liability balance recorded on City financial records as of December 2004.

The current control environment is a direct result of efforts made by staff in the Human Resources and Financial Services Departments to improve internal controls, implement a better tracking system to monitor the individual benefit value, and establish a reconciliation process that will identify situations that need review. As such, while there are some minor findings in this report regarding internal control, the major issues relate to the structure of the benefit, decisions made over the course of the last nine years, and the impact these decisions have had. Specifically:

1. Misinterpretation of legal advice has resulted in the erroneous calculation of taxable compensation for certain retirees. This error, apparently dating back to the inception of the conversion option, means that both the City and the affected retirees have overpaid employment taxes and, in some cases, retirement contributions. Some of the overpayment may be recaptured if efforts are put forth, in a timely manner, to restate W-2s and file amended 941 reports with the Internal Revenue Service (IRS). While this effort will trigger the need for amended tax returns at the individual level, the affected retirees should see a refund of federal and state income taxes as well as an increase in available conversion benefit.
2. After consultation with the City Attorney (now the previous City Attorney), City management paid out the residual value of the conversion benefit to 6 retirees that turned 65 and were no longer eligible for coverage under the City's medical plans. Under existing policy, 27 other retirees may receive a similar payment if a balance exists when they reach this age. Payments, as a result of this decision, total approximately \$100,000 to date and additional payments may reach close to \$200,000. Based on projected

balances, one individual may receive a payment close to \$43,000 if no changes are made.

3. Contrary to City Code provision, the conversion balance is used to pay premiums related to the retiree's spouse and/or dependents if this coverage is selected. According to SRC, §14-81 (i), the benefit is restricted and can only be used to pay the employee's portion of the cost.
4. Retirees, with spouses that work for the City, are allowed to elect the conversion option and then transition over as a covered dependent on the spouse's insurance plan. When this occurs, the cost of coverage is not charged against the conversion balance because the City pays most, if not all, of the premium as part of the compensation package for the spouse. Because the value of the benefit is "frozen," it remains available for future use if the retiree elects to transition back to coverage under his/her name.
5. Employees hired prior to July 1, 1982, and electing the conversion option at retirement have been allowed to submit new W-4s to increase the federal withholding charged against the conversion benefit. To honor the request, the additional amount was deducted from the value of the conversion (a non-cash benefit) and forwarded to the taxing authorities (now a cash transaction). The retiree could then use the funds to offset other tax obligations and, if not needed, receive the excess payment back in the form of a refund. In one case, 87 percent (\$109,000) of the conversion benefit was paid out as additional withholding.
6. Without appropriate authority, management created a death benefit for the family of a post-1982 employee who died while on a training exercise. To do this, Human Resources management treated the employee as "retired." Accrued medical leave was recorded as a conversion benefit, continuation of medical coverage was extended to the family, and premiums charged against the benefit. As a result of this decision, the City is providing almost \$71,000 in non-taxable compensation to the family that is not set out in City Code.

City management was aware, as far back as two years ago, of some of the issues discussed in this report. In April 2003, when payouts of residual value were questioned, management committed to a review of issues, City Code, and development of an internal policy document that would provide direction to staff. We found no evidence that these actions were completed.

The current provisions for medical leave payoff or conversion have cost the City almost \$4 million over the past five years (not including employment taxes and other payments). Over the next two years alone, it may cost the City an additional \$4 million based on the number of employees eligible for retirement, the hours currently booked, and the current rates of pay. The cost will continue to rise because, contrary to the treatment of vacation pay, the accrual

of medical leave does not have a cap. Currently, 11 employees at or near retirement have more than 2,000 hours accumulated. At the current rate of pay, the potential benefit, on an individual basis, ranges from a high of \$122,000 to a low of \$61,000 (assuming the conversion option will be elected instead of the cash option).

Future cost will also increase simply as a result of growth in staff levels. In 1996, the approved budget authorized 1,376 full-time employees; in 2004, the approved budget reflected 1,976 full-time employees.¹ Each new employee added to the pool of existing employees increases the potential liability particularly in light of the fact that an employee can have enough hours accumulated to meet the threshold for vesting in a little over three years.

Routine expenditures, such as the benefits provided to City employees, should be periodically reviewed to evaluate the cost and other options available. As part of the review, the desired objective needs to be evaluated and compared against current outcomes to determine if changes are needed. If this benefit program is re-examined, timing of accruals for leave and payments of benefits such as insurance contributions and car allowances should be reconsidered. Current practice is to pay these amounts prospectively without any pro-rata should the employee terminate during the month. As a result, employees can time dates of retirement to achieve a higher value of final pay. During testing of calculations, we noted one employee that retired effective the Monday after the 4th of July holiday (the 7th of July). The employee was paid for 21 hours of accrued leave; leave that in theory would have been earned by working the entire month of July. In addition, the City contributed the full month of premiums for medical and dental coverage effectively allowing the retiree to postpone this cost for a month.

Recommendations and management's response are located in Appendix A of this report.

¹ This number may not actually reflect authorized positions due to the practice of converting part-time hours to equivalent full-time positions when reporting authorized positions.

BACKGROUND

The City Council, by Ordinance, sets out the system that is to be followed to recruit, select, develop, and maintain an effective and responsive work force. To prescribe, amend, and enforce rules for the employees of the City, the Charter calls for a Civil Service Board. Once approved by the City Council, the rules prescribed by this Board have the effect of law.

The current Chapter of City Code, addressing Human Resources Management (Chapter 14), was adopted in 1987. Modifications have been submitted over the past eighteen years with the most significant revision made in 1996. Only one change, impacting the section on gifts and gratuities, was approved since that revision.

Benefits That Relate to or Impact Accrued Medical Leave

Several benefits are offered to employees as part of the compensation plan. Included within this category are various classifications of leave (vacation, medical, etc.), participation in group insurance plans, and contributions toward retirement plans offered by the State of Arizona. The discussion that follows is limited to benefits relating to or impacting accrued medical leave.

Medical Leave

The City provides paid time off for illness or physical incapacity of the employee or immediate family member, enforced quarantine, if necessary, and medical appointments during work hours. Each full-time regular and probationary employee accrues eight hours of medical leave, prospectively,² each month. There is no cap on the accrual of hours.

This benefit does not vest with an employee. This means that the hours have no value to the employee unless used for the purpose intended. There are two exceptions; use of leave for personal time when certain criteria is met and payoff or conversion of hours at retirement.

Annual Conversion to Personal Leave

After five years of full-time employment, a portion of medical leave may be used for personal purposes. Unused leave from the prior twelve-month period is multiplied by 25 percent³ to arrive at the hours available for this purpose. For example, an employee with six years full-time employment is eligible for

² Medical leave accrues to the employee the first pay period of the month for the upcoming month as opposed to a practice that accrues medical leave at the end of the work period.

³ If an employee accumulates more than 480 hours of medical leave, the percentage used for the calculation increases to 50 percent.

96 hours of medical leave in a twelve-month period. If the employee used no hours, he/she would have 24 hours of personal leave for the next twelve-month period. Personal leave does not accumulate and any use reduces accrued medical leave.

Payoff or Conversion at Retirement

Between June 1987 and March 1996, only employees hired prior to July 1, 1982 (pre-1982 employees), received a payoff, at retirement, of the balance in the medical leave account. The dollar value was based on date of employment and hours available. Retirees hired before September 6, 1976, received 100 percent of the value of hours accrued at this cut-off point using current rate of pay. Hours accumulated after this point, for any pre-1982 employee, were paid based on average hourly base rate over the last five preceding years using a percentage of time available. For hours up to 520, 50 percent of unused leave was paid and the remaining hours were paid at 25 percent.⁴

In July 1996, a medical conversion option was added to City Code as an alternative to the payout option. The cash out was still limited to pre-1982 employees, but any employee, regardless of date of hire, with 300 or more hours of accumulated medical leave at retirement was eligible for the new program. This provision allowed an employee to convert the leave balance and designate it for use in paying health insurance premiums. The election could only be made if the retiree remained on one of the medical plans offered by the City and then only used to pay the employee's portion of premiums until age 65. The value of the benefit is calculated by multiplying the hours available by the rate of pay at the time of retirement.

After adoption of the medical leave conversion policy, the City received an opinion from the outside attorney regarding the taxable nature of the benefit. The direction from legal counsel was two-fold. First, pre-1982 employees would be taxed on the value of the cash payout, regardless of the option chosen. Second, post-1982 employees would not be taxed on any portion of the conversion benefit because there was no option for cash payout.

Health Insurance

The City offers group medical and dental plans for employees. As part of the benefits package, the City contributes towards the cost of the coverage for an employee and the employee's dependents.⁵ All three medical plans and one

⁴ If an employee had accumulated leave prior to the 1976 cut-off, these hours are counted against the first tier (the 520 hours).

⁵ There are certain positions that are considered "non-benefited" and the City does not contribute towards the cost of insurance for employees hired into these positions.

of the dental plans are self-funded. This means the City collects the premiums from participants and assumes the liability associated with the claims presented and the administrative costs to provide these plans.

Continuation as a participant in one of the City's medical or dental plans is available after termination or resignation, under federal requirements, for a period of up to eighteen months after eligibility terminates.⁶ Premiums for this coverage include a 2 percent administrative fee to cover the additional costs associated with extending coverage.

Past practice, although not set out in Ordinance as an employee benefit, has been to allow retirees to continue, at their own cost, as an eligible participant on one of the medical plans (but not the dental plans) offered by the City until age 65.⁷ Administrative fees are not charged for this extension of coverage.

State Retirement System

The State of Arizona provides various retirement plans for state employees, university faculty, and employees of political subdivisions. The City has entered into contracts with the Arizona State Retirement System (ASRS), the Public Safety Personnel Retirement System (PSPRS), and the Arizona Elected Official's Retirement Plan for retirement benefits. Under contractual arrangements, contributions from both the City and the employee are required. The City withholds the employee portion as part of the normal processing of pay and remits both the City and the employee portion to the appropriate retirement system.

The retirement plans offered by the State provide various benefits to participants. Included in this benefits classification is a statutorily mandated payment towards the cost of medical insurance for each retired, contingent annuitant, or disabled member. This benefit is a subsidy that can only be used if the employee obtains insurance from the State or the previous participating employer.⁸ The amount available is tiered based on single or family coverage and eligibility for Medicare. To receive the full subsidy, a participant must have worked for a participating employer for ten years; nothing is available with less than five years of service. A retiree qualifying for the full subsidy would receive \$150 per month until eligible for Medicare and \$100 per month after that point. The amount increases to \$260 when a participant elects

⁶ Certain conditions will extend the continuation period.

⁷ The only reference in City Code, to the continuation of coverage after retirement, rests in the section addressing conversion of accumulated medical leave. Plan Documents approved by City Council in 2003 include retirees as eligible for coverage.

⁸ There are, in certain circumstances, other options available to state retirement system members that are not discussed in this report because the information is not relevant to this audit.

family coverage and drops to \$215 per month when a family member becomes eligible for Medicare. If the actual cost of coverage is less than the maximum set by law, the amount paid will be limited to the actual premium.

Each month the appropriate state retirement system sends the City a check for retirees that elect to stay on City provided medical plans. For retirees with a conversion benefit available, the subsidy reduces the amount charged against the balance. For other retirees, the subsidy is offset against the receivable due and the retiree pays the difference.

Organizational Responsibilities

Three areas in the City have a role in the calculation, and subsequent tracking of balances, for medical leave payoff or conversion. The Benefits section of the Human Resources Department handles the paperwork for retiring employees and, through this process, arranges for the completion of documents to support the election of the payoff (if eligible) or conversion. Benefits staff also tracks the status of enrollment in City provided health plans (both medical and dental) and monitors the payments received by or on behalf of retirees. This responsibility encompasses tracking the balance of each retiree's conversion benefit, the preparation of journal entries for transfers, forfeitures, and other needed entries as well as the processing of cash transmittals for checks received from the state retirement systems. The Human Resources Department also arranges for legal review of issues relating to benefits and compensation.

The Payroll Division of the Financial Services Department is responsible for any calculations. Payroll staff receives paperwork from Benefits and processes the payoff or conversion based on information retained in computerized payroll records.⁹ Calculations are made prior to the final pay period and the process includes a step to make adjustments, if needed, for any use or accrual. Payroll maintains historical records associated with the calculations.

The Accounting Division of the Financial Services Department processes journal entries submitted by Benefits, receipts the payment of subsidies, and reconciles the balance in the medical leave converter account¹⁰ to the spreadsheet maintained by the Human Resources Department. Annually, Accounting arranges for an actuarial report of the potential liability associated with future payouts or conversion of available medical leave. This information

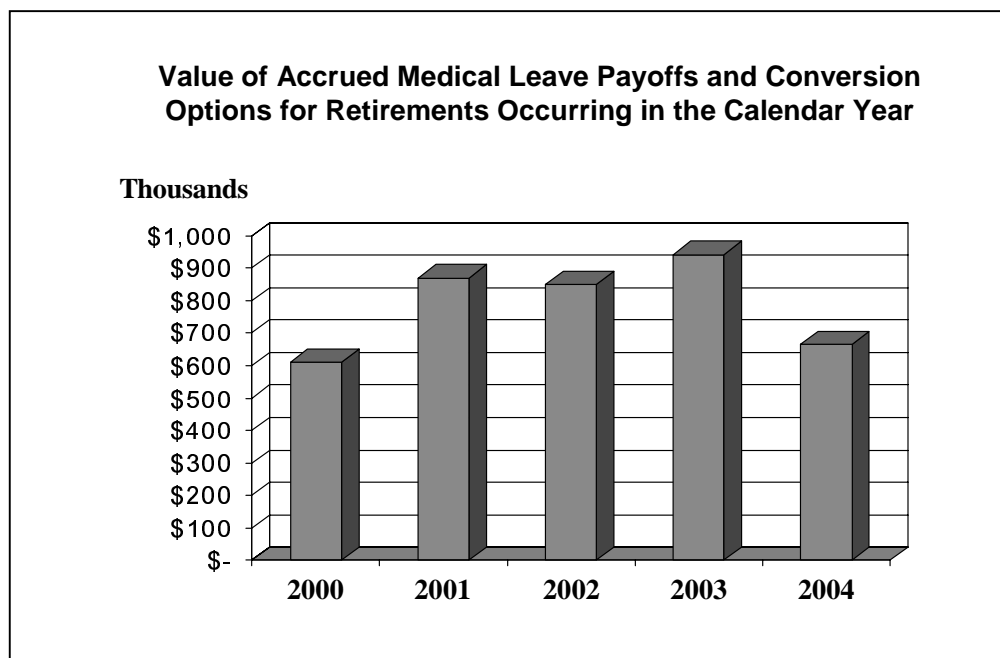
⁹ The process used to calculate the payoff or conversion may have varied in past years based on the computerized records available at that particular time.

¹⁰ This is the account used to track the net benefit the City is currently obligated for.

is used in the preparation of the Comprehensive Annual Financial Report (CAFR).

Cost Associated with Medical Leave Payoff or Conversion

Annual cost to the City for the medical leave payoff/conversion benefit is the actual expenditure necessary to record the liability associated with the value of the conversion and the cash payouts for pre-1982 employees electing the cash option.¹¹ For the calendar years 2000 through 2004, this expenditure has totaled a little less than \$4 million (not including employer portion of employment taxes or retirement contributions). The chart below shows the expenditures by year.



SOURCE: Deductions/earnings reports provided by Financial Services for the year listed.

The actuarial report prepared for the June 30, 2004, CAFR projected the future liability associated with the post-retirement benefit at almost \$8 million based on current workforce age, projected increase in the cost of premiums, and increases in hourly wages.

¹¹ While there have been some forfeitures of residual value, the amounts have been fairly small and the cost information provided here does not contain an offset for those forfeitures. Current practice has been to record any forfeiture as revenue to the self-funded benefits fund and not as revenue to the fund or center in which the initial expenditure was recorded.

At our request, Human Resources staff generated a report identifying known employees at or near retirement based on the number of points or service years. This report lists 137 employees¹² that could elect to retire now or within two years. The potential liability based on current accrued medical leave and current rate of pay, for these employees alone, exceeds \$4.2 million should each retiree elect the conversion option currently available.

Ultimately, the cost will vary based on whether or not a cash option is available and selected by the retiree. Under the current methodology, a pre-1982 employee with 2,000 hours of accrued medical leave and a five year average rate of pay of \$30 per hour would cost the City approximately \$18,000 (\$19,400 if the City needed to pay employment taxes in a cash payout).¹³

This same employee, selecting the conversion option, will cost the City almost \$60,000 since, initially, the full amount will be recorded as a liability (\$67,500 if taxes and retirement contributions must be made). With the conversion option, other factors drive the final cost to the City. For example, if the employee is 57 years old at retirement and frugal when selecting medical coverage, honoring the conversion benefit will require approximately \$6,000 in premiums until age 65. If this same employee covers a spouse, the lifetime payout would increase to almost \$20,000. Under both scenarios, though, the amount needed will be less than the benefit available. Any residual will revert back to the City as a reduction against the cost of the program.

There is no guarantee, however, that this will always be the case. If this same employee retired at age 50, the City could potentially pay fifteen years of premium coverage. If family coverage is needed, the net monthly cost, at current rates, may reach a little more than \$500 per month (\$60,000 would only cover ten years of premiums). If this were the case, no residual value would be available to revert back to the City.

Other Municipalities

The treatment of medical leave varies at the surrounding municipalities in the metropolitan area. The following summaries provide a brief example of the different options that have been chosen. In some municipalities, the accrual of medical leave varies depending on the job classification (i.e., firefighter) and others allow conversion to vacation time that then brings in other considerations as to the payoff of accrued vacation time. Four municipalities (Phoenix, Mesa, Tempe, and Chandler) will pay a subsidy towards the cost of

¹² This total does not include employees participating in buy back agreements or with other earned service, as this information is not captured on the TotalHR system.

¹³ The actual payoff will vary depending on whether the employee participates in ASRS or PSPRS. As well, certain circumstances will impact the calculation of the City's portion of employment taxes.

a retiree's insurance but no municipality reported allowing conversion of leave to create a funding source for future medical insurance premiums. The City of Chandler did, however, report that a plan was being considered.

Chandler

At the City of Chandler, a full-time employee receives a little over 96 hours of medical leave a year. If an employee has been hired for more than a year, the employee can convert 24 hours a year to pay or vacation time. For this option, the employee must have used less than 40 hours of medical leave. At retirement, the City will payout medical leave based on a formula that pays one half of the hours accumulated up to 480 hours. Remaining hours are then paid at a percentage that ranges from 12.5 percent to 20 percent. As part of retiree benefits, the City will pay \$60 per month towards the cost of insurance.

Gilbert

The Town of Gilbert provides approximately 96 hours a year for medical leave and caps accumulated medical leave at 520 hours. Annually, full-time employees, employed for the entire year, can sell back up to 40 hours of medical leave if less than 40 hours were used. Then, each December, employees with more than 520 medical leave hours will receive a payout of 25 percent of the amount that would be forfeited. When an employee resigns, no payout will occur unless the employee has worked for the Town for more than ten years. If the employee meets this criteria, unused medical leave will be paid out at 50 percent of the hours available times the average hourly rate over the last five years. Similarly, if an employee dies while still employed, the beneficiary will receive the payout.

For retirees, the Town will pay 100 percent of the hours at the average rate of pay during the last five years. The 520-hour limit effectively caps the liability associated with this payout.

Glendale

Full-time employees at the City of Glendale accrue approximately 96¹⁴ hours of medical leave per year with no cap on the accrual. At retirement or resignation, a payout of accrued medical leave will be made if an employee has five years of continuous employment. If this criteria is met, the City will pay any hours in excess of 96 hours at one-third of the employees hourly wage averaged over the previous thirty-six months.

Retirees may elect to stay on the City's insurance plan but must pay the required premiums.

¹⁴ Assuming 2,080 paid hours annually.

Mesa

The City of Mesa also provides 96 hours of medical leave a year for regular and probationary full-time employees (benefited part-time accrue 4 hours per month). Accrued medical leave is capped at 1,040 hours and any hours over the cap are converted to vacation time.¹⁵ At retirement, employees will receive 50 percent of accumulated medical leave at the current rate of pay. Similarly, if an employee dies while employed, the beneficiary will receive the payout. If an employee terminates, no value is attached to the accrued hours.

As part of retiree benefits, whatever insurance coverage the employee had before retiring (including dependent coverage), Mesa will pay 50 percent of a retiree's insurance premium if they have ten years of consecutive service. This percentage increases with years of consecutive service up to 100 percent of insurance premiums paid for retirees with twenty years of consecutive service.

Peoria

Full-time employees at the City of Peoria accrue 96 hours of medical leave a year with a cap of 1,040 hours. Annually, in May, any balance over the limit is paid out at a rate of 25 percent using the employee's current pay rate. For retirees, any medical leave balance over 120 hours is paid out at 30 percent using the current pay rate. No payout is made to employees that resign or are terminated.

Phoenix

City of Phoenix operates with five separate unions. Full-time employees receive 10 hours of medical leave per month with no cap on the accrual. If an employee retires, a payout of accrued medical leave will be made if the employee has more than 750 hours accumulated. If this minimum is met, the retiree will receive 25 percent of any amount over 250 hours at their current rate of pay. For Executive and Middle Management classifications, the calculation is 20 percent of any hours available but the 750-hour minimum must be met. If an employee resigns, no payout is made but an employee rehired within five years will have 20 percent of any lost hours reinstated.

Tempe

City of Tempe full-time employees accrue 96 hours of medical leave a year. Annually, employees with more than 480 accrued hours may cash out the excess hours at a rate of 25 percent or elect to leave the hours in the accrual

¹⁵ Accrued vacation is capped and an annual payout is made for excess hours. To be eligible for the payout, the employee must use at least 80 hours during the year.

bank. At resignation or termination no value vests with the accrued hours unless the employee has been with the City for ten years. If this is the situation, an employee receives a payout calculated at 50 percent of the first 480 hours, 25 percent of the next 280 hours, 33 percent of the next 280 hours, and 50 percent of any remaining hours. At retirement, an employee will receive a cash payout of 50 percent or the retiree can elect to convert the hours to vacation leave. If an employee dies while employed, the beneficiary receives a payout equal to 100 percent of the accrued medical leave.

As of July 1, 2004, Tempe will pay for health insurance premiums for retirees with ten years or more of service at 100 percent (excluding dependent coverage) for all but one medical plan.

Objective 1: Verify that procedures are sufficient to ensure that calculations for payoff or conversion are accurate and follow the formula set out in City Code.

FINDING: Current procedures, in general, are sufficient to ensure that the calculations for payoff or conversion are accurate and follow the formula set out in City Code. Changes need to be implemented to ensure consistency and compliance with IRS guidelines when calculating federal withholding.

CRITERIA: City Code sets out the formulas to be used when calculating medical leave payoff or conversion at retirement. For pre-1982 employees electing the payout, accumulated medical leave on the books at September 6, 1976, is paid at 100 percent at the current rate of pay. Remaining hours are paid at a percentage that varies based on the number of hours available multiplied by the average rate of pay. Per the outside attorney's opinion, the payout is considered taxable additional compensation.¹⁶

To be eligible for the conversion option, the employee must have at least 300 medical leave hours accumulated and elect to stay on a City provided medical plan. The calculation of the benefit value is the same regardless of the year the employee was hired. One hundred percent of the medical leave available is multiplied by the current rate of pay to obtain the amount considered additional compensation. For pre-1982 employees, the taxable¹⁷ nature of the income means that taxes and retirement contributions (based on the requirements of the retirement plan in which the employee participates) are subtracted and the net amount becomes the conversion benefit. For post-1982 employees, the value of the conversion amount is not taxable.

The IRS sets out the methodology for calculating federal tax withholding for supplemental pay. Two options are available. The first is a calculation of withholding based on a standard percent. The instructions state that if this methodology is chosen, then the percent set out in the circular must be used. This is the method that has been routinely used by the City.

The other methodology consists of combining the supplemental pay with the regular pay for the most recent pay period. The combined total is used to calculate the withholding as if it is a single payment. Then the tax is calculated for the regular pay and subtracted from the tax on the combined amount. The remainder then becomes the amount withheld from the supplemental pay.

¹⁶ See Objective 4 for a discussion on taxability.

¹⁷ The determination of taxability of the entire conversion amount is based on staff interpretation of the outside attorney's opinion.

This method has not been used in any of the pre-1982 conversions processed in 2003 or 2004.

CONDITION: Staff assigned to the City's Human Resources Department is responsible for obtaining documentation of the employee's election at retirement. A form has been developed (one for pre-1982 employees and one for post-1982 employees) with a place for the employee to mark the option desired and then sign to evidence the selection. This document is then provided to the Payroll Division of Financial Services.

A Payroll representative completes the calculation by researching the available medical leave and rate of pay (current or last five years, if necessary for averaging) and documents the results using a set of master forms kept for pre-1982 employees and post-1982 employees. Different forms are also used based on the state retirement system in which the employee participates and forms used for the pre-1982 employees have lines for the deductions of taxes and the retirement contribution, if appropriate. When the paperwork is complete, a second representative verifies the amounts.

All calculations in our test (29 transactions in total; a random sample of conversions and payoffs from 2003 and 2004, and all taxable conversions processed in 2003 and 2004) tied to supporting documentation. There were, however, two instances in which the calculation of federal withholding did not follow the standard percentage methodology used for all other taxable transactions.

We also selected a sample of retirees (22 from calendar years 2003 and 2004) that were not reflected as receiving a conversion benefit at retirement. In each case, there was a supportable reason for the lack of a conversion benefit (i.e., over age 65 at retirement, selected the payout option, did not have enough hours to qualify, etc.).

CAUSE: Procedures, while not documented, address the need for appropriate documentation and review. The inconsistency in the calculation of federal withholding can be traced, according to the Manager responsible for Payroll activities, to a previous General Manager that requested additional withholding at retirement. When this request was granted, a precedent was set and other requests subsequent to that time have been honored.

EFFECT: Current practice for calculations of payoffs or conversions complies with City Code but procedures are not sufficient to ensure that the City will comply with IRS guidelines for federal tax withholding.

In addition to the issue of non-compliance with IRS guidelines, allowing employees to drive the methodology used to calculate federal withholding for supplemental pay creates a situation that can be used to manipulate the amount of money paid to taxing authorities (i.e., IRS or Arizona Department of Revenue) on behalf of the employee. The request can be driven by a desire to postpone paying taxes to a later period or, in the case of the conversion benefit, to turn a non-cash benefit into cash.

In the two instances found in our test and the initial request processed in 2002 at the request of the General Manager, all three employees had more tax withheld than what would have been calculated using the standard methodology. Moreover, because the withholding of state tax is a percentage of the federal tax, the request for additional federal withholding increased the amount withheld for state income taxes. For example, in one situation the standard percentage methodology would have resulted in a federal tax withholding in the amount of \$25,709 and the state withholding would have been \$5,476. With the change in methodology, the employee had the City withhold \$39,843 for federal taxes and the amount of state withholding grew to \$8,486. In total then, the City paid, on the employee's behalf, almost \$17,000 more in federal and state income tax withholding than what would have been paid using the standard calculation. When extra taxes are paid on behalf of the employee, the value of the conversion benefit available for future use is decreased. This can be a good thing for a retiree in light of the fact that any residual value, at age 65, reverts back to the City.

When the funds are forwarded to the taxing authority for credit to the employee's account, the non-cash benefit generated through the conversion option becomes a cash transaction just as if the City paid the funds directly to the employee because the funds held by the taxing authorities can be used to pay the tax obligation on unrelated income or, if there is no tax obligation, refunded to the employee. When the previous General Manager retired, the direction to withhold additional federal taxes effectively sent 87 percent (\$109,000) of the conversion benefit to federal and state taxing authorities on behalf of the employee. The cash payment generated by this manipulation exceeded, by more than \$54,000, the gross amount that would have been available under the payoff option.

Objective 2: Verify that procedures are sufficient to ensure that use of the conversion funds, for the payment of premiums for medical coverage, is tracked.

FINDING: Current procedures, in general, are sufficient to ensure that:

- The correct beginning balance is recorded when a retiree first becomes eligible for conversion benefits.
- The monthly debit against the available conversion benefit will accurately reflect the cost of premiums for the plan and tier coverage selected by the retiree.
- The ending balance, for the total of all retirees with an available conversion benefit, will reconcile to the liability recorded on the City's trial balance.

However, the process used to track premiums charged against the conversion balance, the receipt of subsidies from the state retirement system, and ending balances is a manual process accomplished through use of an Excel spreadsheet. As a result, the information maintained via this process is prone to errors caused by incorrect input or problems with the transfer of data from one spreadsheet to another. While we found no current errors in calculations, we did find multiple instances in which information such as insurance coverage, tier level, or account status was incorrect.

Finally, the reconciliation process for tracking subsidies from the state retirement system is not sufficient to track situations in which a subsidy may be received for a retiree no longer eligible for coverage.

CRITERIA: When a retiree elects the conversion option, the value is not paid out in cash. Instead, an expenditure equal to the amount of the conversion and the City's obligation for taxes and retirement contribution, if appropriate, is recorded and an offset entry for the value of the conversion (net of taxes paid on behalf of the retiree) is recorded for the future payouts that will occur. Each month, then, a journal entry is made to transfer the appropriate amount from the liability account and credit it to the revenue account for insurance premiums. This entry reflects the payment of premiums, by the City, for each of the retirees with a conversion benefit. When the conversion benefit is used up, the retiree must pay the City for the net amount of premium (total premium less state retirement system subsidy) or terminate coverage.

Separate sub-accounts are not set up for each conversion benefit when the initial liability is recorded. As such, to properly track the benefit that is available to each retiree, procedures must be in place to track each account separately from the process used to record entries on the financial records.

These procedures must accurately record the beginning balance, track the monthly premium charged against each balance, and record the receipt of any subsidy from the state retirement system.

If the procedures are sufficient to track individual accounts:

- Beginning balances should trace to the source documentation created by Payroll staff when calculating the initial value of the benefit.
- Monthly deductions for premiums should agree with the plan selected, the tier of coverage, and the premium set by the City for insurance.
- Credits against premiums due should reconcile to the subsidy payment received from the state retirement system(s).

CONDITION: The beginning balance on the Excel spreadsheet, used by Human Resources staff to track the value of individual conversion benefits, traced to supporting documentation maintained by the Payroll Division (no exceptions out of 34 post-1982 employees retiring between January 2002 and December 2004 and 22 pre-1982 employees retiring between January 2003 and December 2004).

The December 2004 ending balance recomputed correctly for 32 out of 35 retirees added during calendar year 2003 and 2004. In one case, a subsidy payment did not get credited and in two cases, the premium for the first month of retirement did not get recorded. These errors had not been caught but current procedures should make future errors of this nature unlikely.

We did note when completing this test, however, that there are numerous errors on the tracking spreadsheet where information such as the plan provider or tier coverage selected by the retiree is incorrect. These errors necessitated pulling open enrollment forms to determine if the premium deduction was correct or if the insurance coverage listed was wrong. Other errors such as retirement dates and status were also noted.

Also, the tracking spreadsheet currently in use is becoming cumbersome to manage, view on a computer screen, or print out. Currently, the spreadsheet tracks the activity for more than one hundred retirees and the number will continue to grow as more employees retire. Changes in the tracking report or the system would make it easier to monitor individual account balances and identify situations that need review.

The December ending balance on the tracking spreadsheet agreed to the ending balance for the same period on the financial system after adjustments for timing. When completing this test, we noted that the journal entry for the premiums related to retirees participating in the conversion option is

processed a month in arrears (the journal entry posted in December was for November premiums).

The December subsidy payment received from the state retirement system reconciled to the credit against premiums due for each retiree with a conversion benefit after adjustments for subsidies received that should not be and subsidies that were not received. Adjustments of this nature were necessary because 1) the City continues to receive a subsidy from the state retirement system for retirees that are no longer eligible for coverage and 2) the City bills retirees as if a subsidy is received even though it may not actually be paid in the current month.

For the three retirees on the tracking report but no longer eligible for coverage, Benefits staff could only provide one notice of change or deletion as evidence that timely notice was sent to the state retirement system. The copy provided did not indicate the date it was prepared or when the information was sent. As a result, we could not tell if the lag time between end of coverage and termination of subsidy payment is the result of untimely action by City staff or backlogs at the state level.

Finally, current practice is to record the deduction from the conversion benefit balance separate from the reconciliation of the subsidy payment. There is no procedure that results in the reconciliation of the subsidy credit on the conversion benefit-tracking sheet, the billing to other retirees, and the reconciliation of the subsidy payment. We reviewed the December reconciliation and tracking sheet and noted that, while the ending balances agreed, the amount listed on the reconciliation report for the net premium deduction did not tie to the net amount deducted on the tracking spreadsheet. There was no explanation for the difference. We also noted that the reconciliation report did not track the amounts the City had received from the state retirement system that will need to be repaid or the amounts not paid that are due to the City. As a result, if the state retirement system deducts an overpayment in a future period, the information on the reconciliation report will not be sufficient to allow someone to determine if the deduction is correct.

CAUSE: Existing practices.

EFFECT: Using a manual system (albeit a manual process using a computerized spreadsheet application) to track balances of individual conversion benefit amounts is time consuming and can be prone to errors. It also creates a situation in which certain retirees (those that pay the premium to the City) are tracked through the accounts receivable system and others (those with conversion benefits still available or set up for deduction against retirement payments) are not. As a result, there is no common report that can

be used to track all accounts related to retirees and the accounts receivable balance.

Current practice of posting the subsidy payment received from the state retirement system as a net deduction on tracking reports and on the financial system as a lump sum entry does not allow the actual payment to be reflected on each individual account. As a result, if a subsidy payment is not received or is different than what was projected to be received, an adjustment has to be made to correct the credit. Direct posting of the payment, when received, to the individual accounts would eliminate the need to track adjustments and ensure that they are posted correctly.

With the current practice, the revenue from premiums for retirees participating in the conversion benefit option is posted in a different accounting period from the revenue posted for retirees and COBRA participants paying the City directly. With direct pays, the accounts receivable system is used to generate an invoice and the premium gets recorded in the correct month regardless of when the payment is actually received.

Finally, tracking the conversion participants and the subsidy payments separate from the accounts receivable system requires a separate reconciliation process to pick up the credits for retirees on the receivable system, the retirees with conversion benefits, and those that pay the entire amount through the state retirement system. If all retirees were handled in the same manner, one file could be used to post the premium due and the cashier could record the receipt of the subsidy against each individual account and the need for the reconciliation would be eliminated. Reports available from the financial system could be used to identify situations in which premiums and credits did not match.

Objective 3: Verify that procedures are sufficient to ensure that requirements set out in City Code for payoff or conversion of medical leave are followed.

FINDING: While current procedures follow provisions in City Code, past actions have not adhered to City Code provisions:

- The residual value of the conversion benefit has been paid, at age 65, to 7 retirees. Under existing policy, 27 additional retirees processed prior to April 2003 will be eligible for a payoff, if there is a residual value at age 65. For these same employees, the City may be required to pay any residual value to the appropriate beneficiary if the retiree dies before age 65.
- The value of the conversion benefit has also been used, after the death of an employee, to pay insurance premiums for the employee's spouse and dependent children.

CRITERIA: City Code states that the conversion benefit can be used to pay insurance premiums up to age 65 if the employee chooses to remain on a City medical plan. There is no provision for a cash payment of any value associated with the conversion benefit nor is there any provision for the benefit to extend beyond the death of the employee regardless of timing.

A legal opinion in March 1996 supports the conclusion that there is no value to the employee from the conversion option.

You have advised me that the cash equivalent of the lump sum payment that is credited towards the payment of the employee's portion of retiree medical insurance premiums in all cases described in this letter will not be set aside in any special fund or trust. Rather, the amount will be an accounting entry credited for the benefit of the employee. As monthly premiums are paid, debits will be made against the accounting entry until the earlier of the date the employee attains age 65 or the accounting entry is reduced to zero at which time the employee will have no further amounts credited towards retiree medical insurance premiums. Once credited to the accounting entry, the employee will not have the right to have any amounts so credited paid to the employee in cash. Any amounts credited to the accounting entry, which are not ultimately expended for retiree medical insurance premiums will revert to the City. All amounts credited to the accounting entry will be subject to the claims of the City's general creditors.

SOURCE: Letter from outside counsel to Human Resources Manager, March 11, 1996.

The structure of the enabling Ordinance and discussions with staff involved in the creation of the program also supports a conclusion that there would be no residual value.

CONDITION: Interpretations, resulting in program modifications, have created a situation in which certain employees have received or expect to receive benefits that are not in compliance with Code provisions.

1. At some point, City management¹⁸ determined that, contrary to City Code, pre-1982 employees had a “right” to the residual value of the conversion benefit. This decision appears to be driven by the belief that paying taxes on the benefit vested the retiree with ownership of the benefit. Details on when this decision was reached are limited but somewhere between December 1999 and June 2000 changes were made to the form used, at retirement, to document the election of the conversion option.¹⁹ Language was inserted to the effect that any remaining balance at age 65 would be paid out in a lump sum. The form was also modified to add an area where beneficiary information could be listed. There is no indication that City Attorney staff or outside legal counsel reviewed the proposed changes. Examples of the form in use through the end of December 1999 and the modified form put into place in 2000 are included on pages 23 and 24.

In early 2002, one pre-1982 retiree, retiring in the later part of 1999, turned 65.²⁰ There was a residual value of approximately \$2,500 left in conversion benefits when the retiree was no longer eligible to participate on the City’s medical plan and the City paid out this amount to the retiree.

The Program continued on with the same guidelines but without any new requests for payout until the early part of 2003 when a pre-1982 retiree inquired about opting out of medical coverage. He was told that he could terminate coverage and the residual value of the conversion benefit would be paid to him. The check requisition was prepared and, due to the value of the payment, submitted for a higher level of management authorization. At that point, the Human Resources General Manager questioned the practice and discussions were held with the City Attorney’s Office over the issue. While this discussion was ongoing, another retiree turned 65 and inquired about payment.

Ultimately, a decision was reached to not pay the residual balance to the retiree desiring to opt out of coverage. But, the request by the retiree

¹⁸ This is an intentionally nebulous use of the term “management” as no documentation was provided to firmly associate the decision with one person or one group of individuals. Documentation suggests that the discussion of the issue went back as far as July 1997.

¹⁹ Staff stated that the direction for the form change came from the Benefits Coordinating Committee. Historical documentation on the role and make-up of this Committee is scarce as there was no formalized structure for the Committee or requirement for maintenance of documentation of activities. Human Resources staff stated that the structure was formalized and documentation now maintained.

²⁰ Paperwork, at retirement, consisted of the form in use prior to the modification to insert language regarding the payout.

reaching age 65 was honored. At the conclusion of the discussion, an internal policy was implemented to the extent that any retiree processed using paperwork setting out the residual payment would be treated as eligible for payout but that this treatment would not be extended beyond those individuals. The form was modified to remove the language regarding payout and beneficiary and, according to Human Resources staff, pre-1982 employees retiring from that point forward are told that there is no residual value.

2. In February 2002, a police officer died while on a training exercise. The employee was eligible for retirement prior to death but had not yet retired. The City elected to extend retirement benefits as if the employee had retired with some unique arrangements. First, the spouse and dependent children have been allowed to remain on City medical plans even though death of a retiree would normally mean the end of eligibility. Second, the City extended the parameters for the accrued medical leave conversion option and allowed the value of this option to vest with the spouse (who was not a City employee).

CAUSE: Misinterpretation of the taxable nature of the benefit for pre-1982 employees with no indication that the issue was ever sent back to the attorney of record for clarification when the treatment was used as the basis for the position that the City owed the retiree (or the retiree's beneficiary) the residual value of the benefit and corporate culture.

EFFECT: Between February 2002²¹ and this audit work, approximately seven payouts to pre-1982 retirees have been made. Residual values ranged from a little over \$2,500 to slightly under \$25,000 with an average of \$14,051 (total payout at this point, \$98,360). There is no authority in Code for this treatment.

There are 27 retirees still participating in the conversion benefit program from the period during which the modified form was in use. Potentially, it may cost the City more than \$200,000 to honor these agreements. If there are claims from beneficiaries as a result of the death of a retiree, the cost may be more.

Past action also presents an issue with setting precedent. For example, allowing the conversion benefit to extend to the spouse effectively granted the dependents of that particular employee with \$71,000 in additional benefits that are not set out in City Code. Will this action create a potential issue if the City is faced with a request from the family of another retiree?

²¹ Forms setting out the return of the balance were in use prior to June 2002 but the first instance of a retiree reaching age 65 with a residual benefit from the conversion did not occur prior to this point. The cash payout at this point was slightly over \$2,500.

MEDICAL LEAVE CONVERSION AUTHORIZATION

An employee with three hundred (300) or more hours of accumulated medical leave at the time of retirement from city employment, you may elect to convert your accumulated hours to be used, up until the age of 65, to pay your portion of the cost of health insurance. The value of the accumulated medical leave shall be calculated at the hourly rate of pay at the time of retirement.

Employees hired prior to July 1, 1982 have the option to take a medical leave pay-off in cash or to convert their hours to pay for health insurance. You can choose either of the two options, but not both. At the time of retirement, you will be taxed on the value of your medical leave. If you choose the option to pay for your health insurance coverage, the amount remaining after taxes will be placed in an account and used to pay your portion of the health insurance premium up until age 65 or until the account is depleted.

Employees hired on or after July 1, 1982 only have the choice to convert their accumulated medical leave hours to pay for health insurance. If you were hired after July 1, 1982 this benefit will not be treated as taxable income.

To be eligible to convert accumulated medical leave hours to pay for health insurance, the employee at the time of retirement has to be under the age of 65. You must also elect to remain on a city medical plan.

Please complete the authorization form below.

Employee Name _____ SSN: _____

_____ I elect not to convert my accumulated medical leave hours to pay for my portion of health insurance coverage.

_____ I elect to convert my accumulated medical leave hours to pay for my portion of health insurance coverage. This shall be used to pay for my monthly premiums up until the age of 65 or when the value of accumulated medical leave runs out, whichever occurs first. I also understand that under certain circumstances this value may be treated as taxable income at the time of retirement.

FOR PAYROLL USE ONLY

_____ Number of unused medical leave hours _____ Hourly rate of pay at retirement

_____ Value of accumulated medical leave

MEDICAL LEAVE CONVERSION AUTHORIZATION And BENEFICIARY DESIGNATION

Employees hired prior to July 1, 1982 have the option to take a medical leave pay-off in cash or to convert their hours to pay for health insurance. You can choose either of the two options, but not both. No matter which option you select, at the time of retirement, you will be taxed on the value of your medical leave.

In order to be eligible to use the medical leave hours to pay for the health insurance premium, you must be under age 65 and have at least 300 medical leave hours accrued at the time of retirement. You must also elect to remain on a City medical plan. If you choose the option to pay for your health insurance coverage, the amount remaining after taxes will be placed in an account and used to pay your portion of the health insurance premium up until age 65 or until the account is depleted. Any remaining balance at age 65 will be paid out in a lump sum.

Please complete the authorization and beneficiary designation form below.

Employee Name: _____ SSN: _____

_____ I elect to take a medical leave pay-off at retirement

_____ I elect to convert my accumulated medical leave hours to pay for my
portion of health insurance coverage.

BENEFICIARY INFORMATION

Primary Beneficiary

Beneficiary's Name: (Last, First, Middle)

Relationship to You:

Beneficiary's Address:

Secondary Beneficiary/ies (if applicable)

Beneficiary's Name: (Last, First, Middle)

Relationship to You:

Beneficiary's Address:

Signature _____ Date _____

FOR PAYROLL USE ONLY

_____ Number of unused medical leave hours _____ Hourly rate of pay at retirement

_____ Net value of accumulated medical leave (after taxes)

FINDING: Contrary to City Code provisions, the following practices are allowed:

- a. The conversion balance is used to pay the cost associated with covering dependents (spouse, children, and domestic partners).
- b. Retirees can opt out of coverage and become an “eligible dependent” under a plan that covers a spouse as a City employee. When this has been allowed; the conversion account is “frozen” with the anticipation that the retiree will transition back, at some time in the future, and use the balance to pay premiums. While the retiree is on the spouse’s plan, the City picks up the majority, if not all, of the cost of medical and dental insurance for the retiree. This practice allows the retiree to reserve the conversion balance for future use.
- c. Retirees, returning to work within 30 days of retirement, are reinstated back to the original hire date instead of establishing a new hire date.

CRITERIA: According to City Code:

1. Pre-1982 employees can elect the payout or the conversion, but not both.
2. Post-1982 employees cannot elect the payout option.
3. At least 300 hours of medical leave had to be available to elect the conversion option.
4. Benefit of the conversion, for all employees selecting this option, is also limited to:
 - a. Retirees that elect to stay on a City medical plan.
 - b. The cost of coverage related to the employee’s portion of the cost of the health insurance.

As well, for retirees, City Code specifically prohibits re-instatement. Instead, if a retiree is hired back after retirement, the action is to be treated as any other new hire.

CONDITION: Current procedures appear sufficient to ensure that pre-1982 employees will be allowed to elect only one option. One error, dating back to 2001, was noted and discussed with management.

We found no instance in which an employee hired subsequent to July 1, 1982, received a cash payout of accumulated medical leave at retirement. We did find one situation when a retiree was re-hired and, contrary to City Code provisions, the retiree was “re-instated,” a treatment that allowed the original hire date to be carried forward. As a result, he was treated as a pre-1982 employee when he retired a second time instead of the correct post-1982 assignment. While one instance would not necessarily rise to the level of a

finding, this situation is not unique as City management confirmed that it was current practice to consider a retiree eligible for re-instatement.

We found no instance in which an employee was allowed to convert accrued medical leave if less than 300 hours were available.

However, we did note, contrary to City Code provisions, that the conversion benefit has been used, consistently, to pay the entire premium (net of any subsidy received from the state retirement system) instead of being limited to paying the employee's portion of the premium.

We also found five instances in which the conversion benefit was "frozen" for future use. This has been allowed when 1) the retiree returned to work for the City in a benefited full-time position and became eligible for City contributions for health insurance and 2) when the retiree became covered under the Plan provided to a spouse currently employed by the City.

CAUSE: Efforts by Human Resources and Financial Services Management to implement additional controls have strengthened controls.

Corporate culture that allows decisions, effectively policy-level decisions, to be made without a requirement for review, approval, or documentation. As a result, decisions may lead to unintended consequences.

Past corporate culture that encouraged limited written standards in an effort to promote flexibility and creativity based on the circumstances.

EFFECT:

1. Practice as it relates to the initial treatment of the payoff or conversion will adhere to City Code. However, decisions that have led to extension of the conversion benefit to pay premiums for a spouse, significant other, and/or dependent children impacts the ultimate cost of the program to the City. This situation exists because the premiums for coverage are significantly higher when coverage extends beyond employee only. For example, 2004 premiums for employee-only coverage ranged from a low of \$211 to a high \$310. After consideration of the retirement subsidy, the net cost to a retiree would be \$61 to \$160. For family coverage, the premiums range from \$569 to \$775. After the retirement subsidy, the cost to the retiree would range from \$309 to \$515. Using the lowest cost plan for comparison, allowing the benefit to be used for family coverage costs the City \$248 more per month.

By limiting the amount that can be used for premiums, the conversion benefit will either be available for a longer period of time or not entirely

consumed by the retiree by age 65. With the expectation that any residual value, at age 65, would be forfeited to the City, a larger balance at the point of forfeiture would mean a reduced program cost to the City.²²

2. Current practice is such that the City pays 85 percent to 100 percent of the cost of coverage for the spouse and/or dependent children of a current employee. When the City allows a retiree to elect the conversion option with an understanding that the retiree will transition, as an eligible dependent, to a current employee's (i.e., the spouse of the retiree) plan, the City effectively picks up the cost of the premium for the retiree. This means that the retiree can "bank" the conversion benefit for future years while the City considers the ongoing cost of insurance as a compensation package for the spouse.

In one current situation, the City contributes \$215 more a month for coverage for the retiree while he is covered under the wife's plan. If the spouse continues to work for six more years, the City will pick up the cost of insurance for the retiree until he reaches age 65.²³ Since this retiree falls into the time period discussed in the first finding in this section, the arrangement allowed him to select the conversion option to receive the more lenient dollar for dollar calculation of benefit value, conserve the benefit by having the City pay the cost of his insurance as a contribution associated with his wife, and then receive a cash payout of almost \$43,000 at age 65.

In the second situation, a post-1982 employee was extended the same option. While this retiree will not receive the cash payout that the pre-1982 employee is expecting, the treatment allows the retiree to extend the value of the conversion by foregoing the cost of premiums while the spouse works. Other retirees, with coverage available under plans offered by the employer of their spouses, have not been given this same option and must continue to stay on a City plan to maintain the benefit for a future period.

The ability to maintain the conversion benefit, but not be considered the Plan Participant, comes from a broad interpretation of City Code requirements that states the employee "who chooses to remain on the city's medical plan" may elect to convert. Staff has chosen to consider that a retiree on the medical plan as an eligible dependent meets the criterion

²² While the entire cost of the conversion benefit is recorded as the expenditure in the year of retirement, any forfeiture would be treated as revenue. While the revenue would be reported in a future year, the net cost to the City would be reduced.

²³ If the spouse works more years, the City will continue to pick up the coverage until the spouse is no longer employed because there is no age limit for the extension of coverage to the spouse of an eligible employee.

necessary. In order to make this work for future benefits, though, the City has to allow the retiree to opt out of coverage at one point in time and then opt back in when it serves the need of the retiree. This action conflicts with termination clauses set out in Plan Documents and is contrary to existing practice that says that a retiree cannot come back on as an eligible retiree once a decision has been made to opt out of coverage.

FINDING: City Code does not address continuation of coverage under one of the City's medical plans as a retirement benefit. In absence of Code provisions, management discretion and parameters set out in Plan Documents have been used to establish City policy as it relates to the benefit.

CRITERIA: Treatment of retirees, receiving the benefit of the conversion of unused medical leave hours, should follow established policy as it relates to the continuation of coverage for both the retiree and dependents.

CONDITION: City Ordinance does not address continuation of coverage for retirees or dependents. The only discussion of retiree participation on City provided group medical plans is found at Section 14-83(i):

Any employee having three hundred hours or more of accumulated medical leave at the time of retirement, who chooses to remain on the city medical plan, may elect to convert and designate his or her accumulated hours to be used, up to age sixty-five (65), to pay the employee's portion of the cost of the health insurance.

A strict interpretation of this provision, without any other guidance in Code, would mean that only retirees with more than 300 hours of accrued medical leave would have the option to stay on a City medical plan.²⁴ If this situation existed, the retiree could then use funds, converted from accrued medical leave available at retirement, to pay premiums for the retiree up until age 65.

This is not how the continuation of retiree coverage has been implemented. Under current practice, any retiree has the option to stay on one of the City's medical plans. Moreover, retirees can continue coverage for an eligible dependent (spouse, domestic partner, or other dependent) or add/delete eligible dependents as a result of a qualified life change or at any open enrollment period. Basically, the treatment is the same as that extended to a current employee except the retiree:

- Must pay the premium for the level of coverage selected.
- Is no longer eligible for coverage (retiree and dependents) after age 65.
- Cannot opt out of coverage and then return as a plan participant later.
- Cannot continue coverage under one of the City dental plans.

Plan Documents, approved by City Council in December 2003 for the coverage period January 2004 through June 2005, were reviewed for the terms related to the extension of coverage.

²⁴ Federal law requires that the City extend continuation coverage for eighteen months after termination.

MMSI Plan

Under the MMSI Plan²⁵ retiree coverage is outlined as:

Employees and City Council members who retire from the City of Scottsdale and have met the retirement criteria for their retirement system are eligible to continue coverage under the Plan for the retiree and eligible dependents. Eligibility under the Plan will end effective the first (1st) day of the month in which the earliest of the following events occurs:

- 1. The retiree reaches age 65.*
- 2. The retiree opts out of such coverage.*
- 3. The retiree fails to pay necessary premiums to the Employer within established payment schedule as communicated directly to the retiree.*

The Plan states further:

During the retiree's continuation period, the retiree has the same rights to add dependents as outlined for employees in 2.4 b, d and e.²⁶

Aetna Plans

For the Aetna EPO and PPO Plans, the coverage for a retiree is addressed as an eligibility requirement. According to the Plans, enrollment is based on eligibility requirements. One requirement listed is:

Retired employees and retired members of the City Council who are under age 65 and who draw benefits within 60 days of retirement under the Arizona State Retirement System, the Public Safety Retirement System or the Elected Official's Retirement System and are not eligible for Medicare/Medicaid benefits.

Termination of coverage for retirees is addressed in a section titled "When Coverage Ends." The provisions are:

Coverage for retirees will end on the first day of the month in which the earlier of the following events occur.

- 1. The retiree reaches age 65.*
- 2. The retiree dies.*
- 3. The retiree opts out of such coverage.*
- 4. The retiree fails to pay necessary premiums to the Employer with the established payment schedule as communicated directly to the retiree.*

²⁵ MMSI was previously known as the Mayo Plan.

²⁶ B, d, and e of 2.4 would allow a retiree to add a dependent during open enrollment, if the dependent lost other coverage or at the point of birth, adoption, or legal guardianship of a child.

This is the extent of discussion in the Aetna Plans. Unlike MMSI, there is no discussion of adding dependents during the continuation of coverage nor is there any discussion of the continuation of coverage for dependents that are covered at the time of retirement. The Plans do state, however, as part of the discussion on eligibility, that the spouse, dependent children, and domestic partners are eligible to join.

The Plan Documents appear to support the current practices in place but there are instances in which practice is contrary to terms in the Plan Documents (extension of coverage after death of a retiree and ability to opt out with an expectation to return as the covered individual at a later point in time).

CAUSE: Management focus on other issues.

EFFECT: Failure to document City policy on retirement benefits creates an environment in which there are no set boundaries to guide the employees that make decisions. Without written policy to drive information that is presented in the Plan Documents, the guidance that is available is not consistent.

As a result, certain employees may get preferential treatment not extended to other retirees simply because of the circumstances of a particular situation (i.e., benefits extended to the family of an employee who died while working may be greater than those extended to a family if the death is caused by other circumstances). The failure to document policy also creates a situation in which potential scenarios may not be explored and considered. For example, under current practice:

- There is no age parameter for the spouse or domestic partner of a retiree. As a result, the City will terminate coverage for a retiree (and the eligible dependents) at age 65 but will continue to extend coverage to a Medicare-eligible spouse or domestic partner regardless of age simply because the retiree is considered eligible for coverage.
- Continuation of coverage under City dental plans, as a retirement benefit, is not available based on staff interpretation of the language in Section 14-83 and past actions. There is no documentation, however, to support that this restriction adheres to or runs contrary to Council policy because the issue was never presented to Council for consideration.

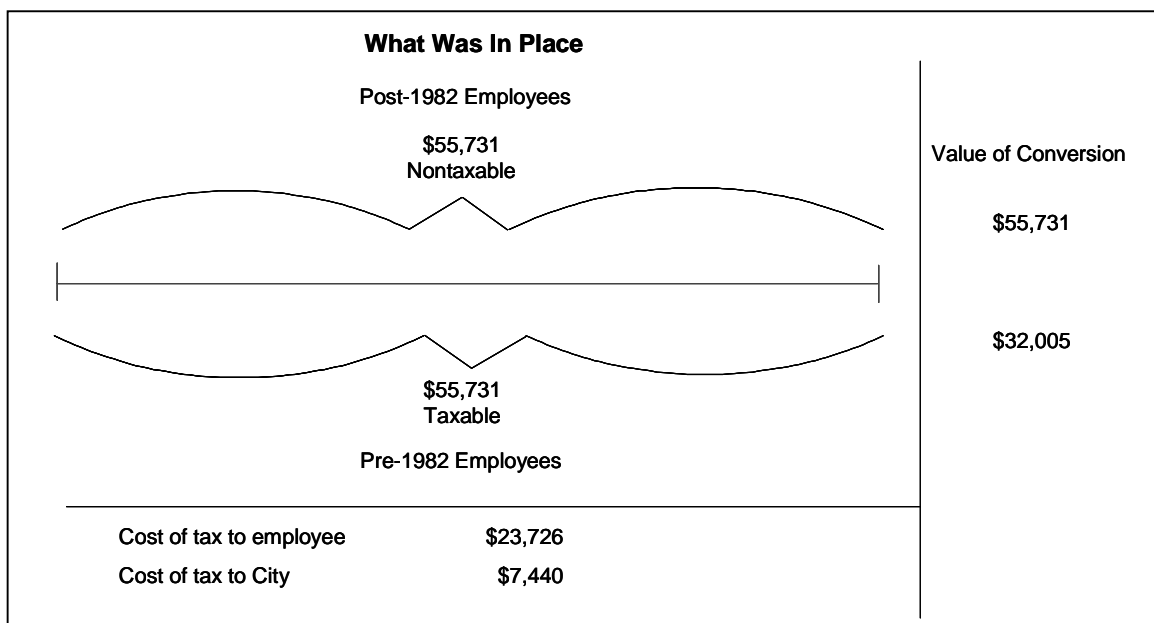
Objective 4: Determine if the City has been handling the taxable nature of the conversion benefit correctly.

FINDING: The City has miscalculated taxable compensation associated with the selection of conversion options by employees hired prior to July 1, 1982.

CRITERIA: The value associated with the conversion of accrued medical leave is a tax-free transaction when designated for use to pay medical insurance premiums. When an employee can elect to receive cash, the value of the cash that could be received is taxable, whether or not the value is ultimately received in that fashion.

If the value of the conversion option is greater than the value of the cash, then only the value attributed to the cash option is taxable. This treatment is correct regardless of the fact that the retiree may not use the entire value of the benefit and will ultimately forfeit amounts, at age 65, that are not used.

CONDITION: The City has erroneously calculated the taxable earnings for pre-1982 employees electing the conversion option. The insert below shows how the conversion option has been treated and the cost to the City and the retiree if the entire conversion benefit is taxed.

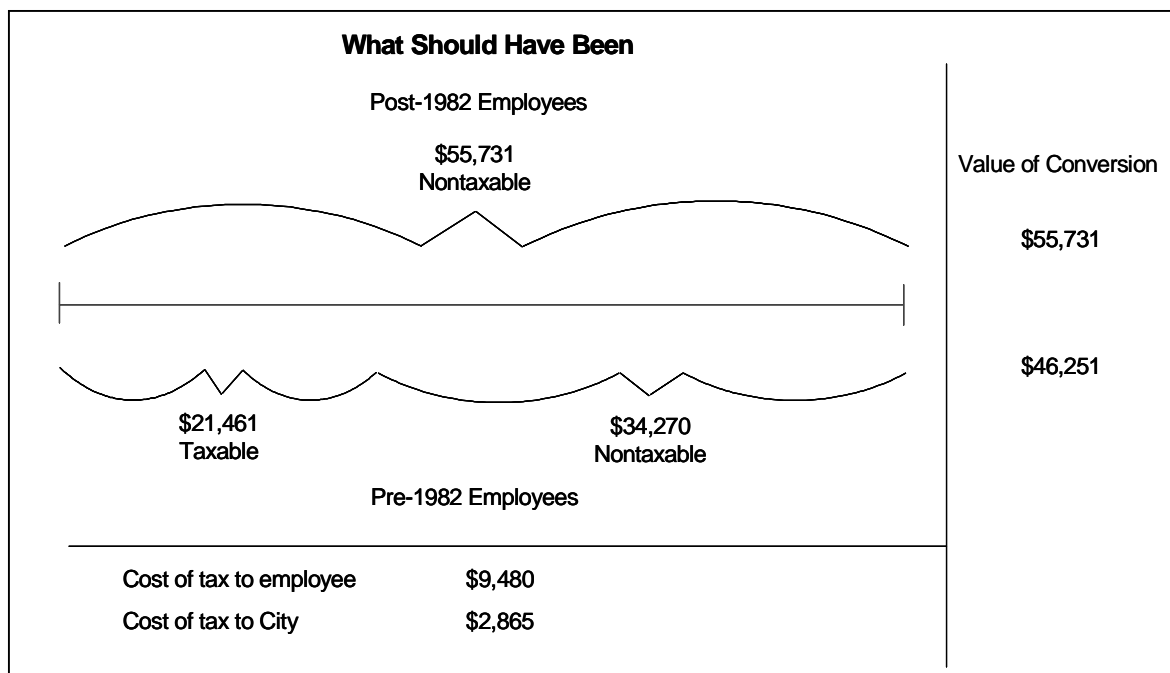


The value of the conversion benefit shown in the box to the right of the picture shows the difference between the benefit available to pay insurance premiums. A post-1982 employee, at retirement, receives the entire value of

the conversion for use while the pre-1982 employee only receives what is left after the payment of taxes and, if required, the retirement contribution.

CAUSE: Misinterpretation of guidance from outside legal counsel as to the taxable nature of the benefit for pre-1982 employees with no indication that the issue was ever sent back to the attorney of record for clarification when the taxable nature of the income was questioned.

EFFECT: Overpayment of employment taxes and retirement contributions by both the City and retirees. The overpayment of employment taxes, retirement contributions, and additional withholding for federal and state withholding taxes reduced the value of the benefit credited for use in paying insurance premiums. As a result, retirees with this tax treatment had fewer dollars available to pay insurance premiums. In addition, retirees have paid income taxes on a benefit that has been treated as tax-free for other retirees hired after July 1, 1982. The picture below shows how the tax should have been computed.



The value of the cash option, in this example, is \$21,461 and the tax obligation, for both the City and the retiree, is significantly less. As a result, the retiree receives more conversion benefit than what would be available under the methodology currently in use.

Overpayments may be recoverable through the issuance of corrected W-2s, amended quarterly tax returns, and amended reports to the state retirement

system. For pre-1982 employees retiring between March 1996 and 2000, an overpayment also occurred but this amount will not be recoverable due to time limits on amending tax returns.²⁷

For a retiree falling within the timeframe for corrected reports, the re-issuance of W-2s will allow an amended tax return to be filed with the potential to generate a refund of federal and state income taxes. The retiree will also benefit from the refund of employment taxes that were paid on behalf of the employee when these payments are received and credited to the retiree's conversion benefit.

Finally, the misinterpretation overstated earnings reported to the ASRS for pre-1982 employees at retirement. This created a significant benefit to certain highly placed employees participating in ASRS where the error resulted in more than twice the amount than what should have been reported. When factored into the income-averaging formula that is available to a retiree that entered the System (ASRS) prior to 1984, the additional earnings inflate the retirement stipend.

Under the correct interpretation, only the cash payout (i.e., the amount that the retiree would have received if the conversion option was not available) would be reported as additional earnings. Using the scenario set out in the picture above, the retiree would have been able to include only \$21,461 in the income averaging; almost \$34,000 less than what was reported.

²⁷ While tax calculations were wrong in prior years as well, 2000 and prior years are considered closed. This determination is made based on regulations that state that tax periods are closed three years after the due date for the tax return. Income tax returns for 2000 would have been due April of 2001 effectively closing the year in 2004.

Objective 5: Determine if there are other issues that need to be addressed.

FINDING: Procedures need to be formalized for review and approval of the annual actuarial study used to establish the value of post-retirement benefits.

CRITERIA: Information and assumptions presented for use in preparing actuarial studies of future liabilities should accurately reflect the conditions at the time the study is completed.

CONDITION: The actuarial report prepared in March 2004 for use in the preparations of the June 2004 financial statements does not accurately reflect the medical leave payoff or conversion options.

For example, under Plan Summary:

1. There is no discussion of the cash payout option for pre-1982 employees. Because there is no minimum criteria and no age restriction under the payout option, certain employees hired before July 1, 1982, will receive a retirement benefit that is not addressed in the actuarial report.
2. Under "Retirement Benefit," there is a statement that any unpaid balance will be paid out at age 65 to employees hired prior to July 1, 1982. This is contrary to current City position on payouts.
3. Under "Death Benefits," there is a statement that an eligible employee's beneficiary receives the cash value from the medical payoff plan, less the medical premiums paid. The City has never offered a program with these parameters.

Under "Assumptions," the parameters used to project future rates are discussed. The premiums set out in the document are from 2003 even though there was a significant change in both Plans and rates when new contracts were approved in November 2003 for 2004 coverage. More importantly, only the rates for employee coverage and employee spouse were used under the assumption that no adjustment needed to be made for retirees that would choose a higher coverage level. In reality, more than 20 percent of the retirees participating in the medical conversion option chose coverage that required payment of premiums for dependent coverage.

CAUSE: The Accounting Director stated that it was past practice to provide a draft report for review but that this was not followed when the 2004 report was prepared because it was a "roll-forward" report prepared by projecting 2004 based on January 2003 valuation results.

EFFECT: Information used by the City to project future liabilities may be based on invalid assumptions. Moreover, documentation setting out erroneous program parameters may give current City employees or retirees a false representation of expectations.

FINDING: The residual value of any conversion option should revert back to the center in which the expenditure was initially recorded. In absence of the continuation of the center, the revenue should be credited to the fund.

CRITERIA: The expenditure related to the conversion benefit is charged as an operating expense in the year the employee retires. If there is any residual value, the revenue should be returned to the fund that initially absorbed the expenditure.

CONDITION: Policy adopted by the City is to credit the forfeiture of any residual balance to the self-funded benefits fund instead of the fund that initially absorbed the cost related to the expenditure.

CAUSE: Management stated that this decision was made in light of the fact that the forfeiture may occur many years subsequent to the recording of the expenditure.

EFFECT: While the revenue generated as a result of the forfeiture of conversion benefits may be immaterial (a little over \$26,000 between July and December 2004) given the value of the self-funded benefits fund, the current treatment fails to match the revenue with the initial treatment of the expenditure. It also allows management to transfer revenue to the self-funded benefits fund outside the review of Council.

FINDING: The City has not reported taxable compensation when the conversion benefit has been used to pay the premium for domestic partner coverage.

CRITERIA: Contributions for the cost of health insurance for a domestic partner do not qualify for tax-free treatment. As such, when the conversion benefit (treated as tax free) is used to pay the premium for domestic partner coverage, the City must report the value as compensation.

CONDITION: Under current practice, the City allows retirees to cover domestic partners in the same manner as what is extended to employees. Two retirees, participating as post-1982 employees with a conversion benefit, have requested coverage for a domestic partner but the City has not reported the additional income associated with this coverage.

CAUSE: Failure to identify the issue.

EFFECT: The City has failed to report the value of the additional premium associated with the domestic partner coverage under these circumstances. One instance dates back to the beginning of 2003 while the second only came into effect in the early part of 2004. Value associated with the taxable benefit for 2004 was \$340 per month for one retiree and \$253 for the second. This does not include any employment taxes if this payment is required.

SCOPE AND METHODOLOGY

The objectives for this audit were to:

1. Verify that procedures are sufficient to ensure that calculations for payoff or conversion are accurate and follow the formula set out in City Code.
2. Verify that procedures are sufficient to ensure that use of the conversion funds, for the payment of premiums for medical coverage, is tracked.
3. Verify that procedures are sufficient to ensure that requirements set out in City Code for payoff or conversion of medical leave are followed.
4. Determine if the City has been handling the taxable nature of the conversion benefit correctly.
5. Determine if there are other issues, related to the medical leave payoff or conversion benefit, that need to be addressed.

The scope was limited to medical leave payoff or conversion activity from 2002 through December 2004. The scope of work was initially limited to reduce the need to pull documents kept off-site. Because there were no significant errors with the documentation reviewed from 2002 through 2004, the scope was not expanded.

For activity related to calendar year 2002, work was limited to verifying beginning balances for post-1982 employees added to the conversion tracking report and tracing the ending balances from December 2002 to the 2003 tracking report.

The review of internal control was limited to the calculation of payoff or conversion and the tracking of the liability associated with the benefit.

To complete the work, we interviewed staff in Financial Services and Human Resources and met with a City Attorney representative as well as outside legal counsel to discuss the taxable nature of the conversion option. We reviewed the actuarial report, used for the June 2004 CAFR, for the City.

We traced liability amounts for post-1982 employees retiring in 2002, 2003, and 2004 to tracking reports to verify the accuracy of the amount recorded. For pre-1982 employees, we verified that the conversion value, net of taxes, agreed to the tracking report for all elections occurring in 2003 and 2004.

We tested the correctness in which eligibility for medical leave payoff or conversion was determined by identifying retirees not on the current conversion list. Twenty-two retirees were selected and Payroll was asked to provide supporting documentation as to why there was no conversion balance.

There were no exceptions as each retiree not on the list fell into an appropriate category (over age 65 at retirement, election of the cash payout option, not enough hours to meet the criteria, or did not elect to participate on a City medical plan).

We also tested the accuracy of calculations. A random selection of 12 retirees (10 with a conversion balance and 2 with a cash payout) was developed from the population of all retirements between July 2003 to December 2004 receiving either a cash payout or electing the conversion option. Documentation was requested to support the hours used and the rate of pay. Each calculation agreed to the screen printout showing accrued medical leave and current rate of pay. Taxes and retirement contributions were then recalculated using the percentage stated on the form. One amount, for federal tax withholding, did not agree with the formula listed on the calculation documentation. Additional documentation was requested from Payroll to support the calculation and the explanation was that the retiree was allowed to submit a form requesting that the City withhold additional taxes. The amount listed was added to the amount calculated from the percentage.

To determine if this was the only instance in which this option was allowed, all pre-1982 employees retiring in 2003 and 2004 and electing the conversion option were selected (22 in total). Documentation was obtained and the calculation of taxes was recomputed. One other instance was found in which the federal withholding did not agree with the stated formula. In this particular case, a different form was used when completing the calculation. The form stated that the federal withholding was to be based on "standard deduction plus additional amount." For this particular individual, the net effect of the change in the withholding methodology increased the amount of the federal tax withheld by a little over \$14,000. For calendar year 2002, the review was limited to analytical procedures that compared the total conversion benefit to the net benefit to identify any situations that fell outside the normal range.

We also reviewed 2002, 2003, and 2004 tracking reports to identify situations in which treatment for a particular retiree appeared to be different than what was extended to other retirees and obtained an explanation from Human Resources. For all retirees processed in 2003 and 2004, we recomputed the deductions against the conversion benefit to verify the ending balance at December 2004. For the December deduction, we reconciled the receipt of subsidy payments from the state retirement system to the supporting documentation to verify that the City received the payment for each retiree. In cases where a retiree was no longer eligible for coverage, we requested documentation to evidence that Human Resources staff provided the state retirement system with timely notice that coverage was no longer provided. We traced the journal entries recorded on the December 2004 trial balance to

the supporting documentation and traced the forfeiture recorded back to the tracking report. Questionable transactions were discussed with Human Resources and Financial Services to obtain further clarification.

Certain findings were discussed with management and not considered material for inclusion in the body of the report. These included:

1. Incorrect posting of the premiums associated with retirees participating in the conversion option. At the time of audit work, the entries to record the revenue associated with the premiums were recorded against an expenditure account instead of the appropriate revenue account. The Accounting Director directed staff to correct past activity in fiscal year 2004 and instructed staff on the correct posting for future months.
2. Inappropriate inclusion of a retiree on the conversion tracking report when there was no benefit. In this particular situation, the employee opted the payoff of accrued medical leave and the request was processed. But the employee and a value associated with medical leave was also added to the conversion tracking report. As a result, the City paid the employee for accrued medical leave and also paid premiums for medical coverage from July 2001 through February 2003 before the error was caught. Changes in procedures and the implementation of a process to track the liability associated with the conversion option should eliminate future errors of this nature.
3. Payment of accrued medical leave to an employee that has been classified in a job share position as far back as 1994. The language used in 1987 (when the current Ordinance for Human Resources Management was crafted) is not clear as to whether or not the cash payoff option was to be made available to all employees or only full-time employees. Language added in 1996 did nothing to clarify the issue but, in fact, appears to support a conclusion that the payoff should only be available to employees appointed to a full-time position prior to July 1, 1982. This issue needs to be clarified and procedures implemented, if the ultimate resolution is to exclude any employee not hired into a full-time position prior to 1982. In reality, information may not be readily available, should a decision need to be made to exclude someone based on initial hiring classification.
4. Current practice continues to use social security numbers, in some instances, as a means of identifying retirees. For example, the Excel spreadsheet used by staff in Human Resources to track individual benefit balances includes a column with social security numbers. While this spreadsheet is only used internally, the information is available to staff in Financial Services because the spreadsheet is used to reconcile the liability account.

5. Lack of documentation to support timely notice to the state retirement system when a retiree is no longer eligible for insurance coverage. Three retirees on the conversion tracking report ceased to be eligible for insurance coverage due to age but the City was still receiving the subsidy payment from the state retirement system when this audit was completed. In one case, coverage should have terminated as of July 2004. Human Resources Management could provide a copy of the change notice for this individual but could not document the date in which notice was sent to the state retirement system. Moreover, the copy provided was not completed accurately or completely. According to management, copies are now put in files on a consistent basis but this does not explain why a copy from July 2004 was available but more recent forms were not.

Audit work was conducted in accordance with generally accepted government auditing standards as they relate to expanded scope auditing in a local government environment and as required by Article III, Scottsdale Revised Code, Section 2-117, *et seq.* Audit testing was completed January 21 through February 18, 2004. Cheryl Barcala, with assistance from Gail Crawford, completed the work.

APPENDIX A - MANAGEMENT RESPONSE/ACTION PLAN

MEMORANDUM

April 1, 2005

TO: Cheryl Barcala, City Auditor

FROM: Neal Shearer, Assistant City Manager
Craig Clifford, Chief Financial Officer

RE: Medical Leave Payoff or Conversion Audit No. 0512

The attached action plan is in response to Audit No. 0512 relating to the medical leave conversion program. Financial Services and Human Resources staff have worked together to provide a joint response and a coordinated action plan.

Prior to the commencement of the audit, staff in Financial Services and Human Resources had initiated steps to improve tracking and reconciling of the medical leave conversion program. As a result, many of the issues and recommendations in this audit have already been addressed or completed. We are in agreement with the balance of the recommendations or their intent, and further research is required on a few to determine the best course of action.

The medical leave conversion policy was authorized by the City Council in 1996 to provide an incentive for employees to conserve accrued medical leave, the equivalent value of which could be converted to a fund to pay for health care premiums at retirement. It also serves as an incentive to keep experienced employees with the City until they retire. Consequently, dozens of retirees are already utilizing this benefit to fund their health care premiums and many active employees are factoring this benefit into their retirement planning.

When former management drafted the medical leave conversion policy in 1996, they did not anticipate the full range of scenarios that could surface in the application of the policy and the recommended Code language left some room for administrative interpretation. In recent years, management has attempted to address such interpretations in a manner that is reasonable and not inconsistent with the Code or policy intent. For example, in 2003, senior management intervened to correct a practice that was not consistent with the Code and to begin steps to further improve administrative controls and program management.

As both a retiree health insurance benefit/subsidy and a growing fiscal liability to the City, the medical leave conversion program warrants continued and thoughtful oversight and review. Management will be happy to discuss in more detail the issues and opportunities associated with this audit and this program that was implemented nearly ten years ago.

C: Jan Dolan, City Manager
Lisa Murphy, Accounting Director
Joyce Lira, Human Resources Director
Cyndi Coniam, Benefits Manager
Laura Fanning, Payroll Manager

ACTION PLAN

No.	Recommendations and Management Response
	The Financial Services General Manager should instruct staff to develop and document procedures sufficient to ensure that:
1	The methodology used for calculating federal withholding tax on supplemental pay follows one of the acceptable methods outlined by the IRS (MEDIUM).
	<p>Management Response: Agree/Completed. Payroll withheld additional amounts per W-4 filings as requested by three employees. However, the final checks were not properly calculated under the aggregate method in accordance with the IRS regulations for these same three employees. Based on policies and procedures recommended by the Human Resources staff, payroll has instituted a policy to only allow participants entering into the medical leave conversion program to calculate federal withholding at the flat percentage of tax as one acceptable method listed in the Internal Revenue Service Circular E for supplemental wages.</p> <p>Responsible Party: Financial Services Completed By: Completed</p>
2	The assumptions, methodology used in actuarial projections for post-retirement benefits, and the draft report prepared by the actuarial firm are reviewed and approved by Human Resources Management prior to finalization (HIGH).
	<p>Management Response: Agree. A joint team will review actuarial assumptions each year prior to the report being compiled by the independent actuary. This team may include, but is not limited to the following individuals: The HR Benefits and Administration Manager, HR Sr. Benefits Analyst(s), Accounting Coordinator, Accounting Director, and the Chief Financial Officer. Other individuals may be asked to review the assumptions as necessary.</p> <p>Responsible Party: Financial Services Completed By: Ongoing</p>
3	Taxable compensation associated with the selection of the conversion option by employees hired prior to July 1, 1982, is properly calculated (HIGH).
	<p>Management Response: Agree/Completed. Based on the most recent letter of clarification from outside legal counsel dated March 16, 2005, Payroll has implemented a procedure to tax only the cash payout portion of pre-1982 employees regardless of the method chosen (medical leave conversion or cash payout).</p> <p>Responsible Party: Financial Services Completed By: Completed</p>

No.	Recommendations and Management Response
	The Human Resources General Manager should instruct staff to:
1	Continue to improve the process used to track premiums charged against the conversion balance; improve the monthly reconciliation process to ensure that premiums are charged correctly and subsidy payments from the state retirement systems are properly reflected, and implement procedures to record the revenue for insurance premiums in the month due (LOW).
	<p>Management Response: Agree/Completed. Human Resources and Accounting staff initiated steps in the fall of 2003 to improve the reporting and tracking processes. Accounting and Human Resources will continue to work on improvements based on the recommendations of this audit, while considering that the cost of process improvements should not exceed expected benefits.</p> <p>Responsible Party: HR/Financial Services Completed By: Ongoing</p>
2	<p>Prepare and submit to City Council for consideration:</p> <p>a. A modification to City Code sufficient to clarify that it is the intent of the City to allow the conversion benefit to be used to pay the entire premium due, net of any subsidy available from the state retirement system, regardless of the coverage or tier selected by the retiree (HIGH).</p> <p>b. An ordinance addressing continuation of coverage for retirees as a post-retirement benefit and parameters such as dependent coverage, domestic partner coverage, length of continuation benefits, and responsibility for premiums (HIGH).</p>
	<p>Management Response: Agree. Human Resources staff will review, develop and submit a recommended plan to management and clarify either through the City Code and/or Administrative Regulation.</p> <p>Responsible Party: Human Resources Completed By: 09/01/05</p>
3	Review options for continuation of coverage for retirees when a spouse works for the City or when other coverage is available and submit, for management approval, a proposed policy for handling situations such as this (MEDIUM).
	<p>Management Response: Agree. Currently two city employees continue coverage for their retiree spouses and were given the option to suspend utilization of their medical leave conversion pool to a later date. Human Resources staff will review the matter and submit a recommendation to management for approval. See response to number 2.</p> <p>Responsible Party: Human Resources Completed By: 09/01/05</p>

No.	Recommendations and Management Response
4	Comply with City Code when a decision is made to fill an open position and the individual hired is a City retiree (MEDIUM).
	<p>Management Response: Agree/Completed. In a few cases, staff has applied the provisions of Sec 14-42 "Reinstatement" which applies to non-retirees and restores certain benefits to the reinstated employee, rather than applied Sec 14-64 "Resignation/Retirement" which does not restore benefits to retirees upon return to the city. Prospectively, staff will consistently apply the provisions of Human Resources Ordinance Sec14-64.</p> <p>Responsible Party: HR/Financial Services Completed By: Completed</p>
5	Review past practice of allowing the conversion benefit to be used for domestic partner coverage and submit, for management approval, a recommended policy. Obtain legal guidance on tax consequences if this practice is allowed to continue (MEDIUM).
	<p>Management Response: Agree. Human Resources staff will review this option and submit a recommendation to management for approval. See response to number 2.</p> <p>Responsible Party: Human Resources Completed By: 09/01/05</p>
	The Financial Services General Manager and Human Resources General Manager should instruct staff to work together to:
1	Consider the appropriate accounting treatment when a conversion benefit reverts to the City and document, for management approval, the methodology selected (LOW).
	<p>Management Response: Agree. Staff's current practice of reverting forfeited conversion benefit funds at age 65 to the self-insured benefits fund is a generally accepted accounting method. This practice will continue to ensure forfeited funds lower the overall self-insured benefit costs to the City and its employees.</p> <p>Responsible Party: Financial Services Completed By: Completed</p>

No.	Recommendations and Management Response
2	Develop a plan to address the issue of taxable compensation for pre-1982 employees retiring since inception of the conversion option and prepare any corrected W-2s, quarterly tax reports, or other documentation that will allow the City to recoup any employment taxes paid in error (HIGH).
	<p>Management Response: Agree to develop plan. Based on the current statute of limitations for recovering taxes paid in the past, only 1/5th of the amount listed in the audit report has the possibility of being recovered by the City as of March 2005. Financial Services and Human Resources will review, develop and submit a recommendation to management on a plan to address the issue of taxable compensation for pre-1982 retirees, consistent with advice from legal counsel.</p> <p>Responsible Party: Financial Services Completed By: 09/01/05</p>
3	Obtain a legal opinion from the City Attorney as to the City's obligation to pay any residual conversion benefit to a pre-1982 employee or to the beneficiary of the retiree that elected the conversion option (HIGH).
	<p>Management Response: Agree/Completed. Human Resources requested and obtained a legal opinion from the City Attorney's office in April 2003 and acted in accordance with that legal advice to change the medical leave authorization form and to honor any prior authorization forms that had been signed by retirees. If the City Auditor's intent is that this legal opinion be reassessed, such action must be carefully weighed against potential litigation risks should the City's legal position change from the City Attorney's direction in 2003.</p> <p>Responsible Party: Human Resources Completed By: Completed</p>